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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FCC MAIL SECTION

In the Matter of	)	
	)	
Price Cap Performance Review	)	CC Docket No. 94-1
for Local Exchange Carriers;	)	
Treatment of Video Dialtone Services	)	
Under Price Cap Regulation	)	

SECOND REPORT AND ORDER AND
THIRD FURTHER NOTICE OF PROPOSED RULEMAKING

Adopted: September 14, 1995; Released: September 21, 1995

Comment Date: October 27, 1995
Reply Date: November 17, 1995

By the Commission:

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I. INTRODUCTION

A. SUMMARY

1. In this Order, we adopt rules regarding the price cap treatment of video dialtone common carrier service provided by local exchange carriers (LECs). After examining the record

generated in response to the Further Notice of Proposed Rulemaking (FNPRM),[1] we: (1) establish a separate price cap basket for video dialtone service that will not include any other broadband services; (2) assign a zero "productivity" or X-Factor to the video dialtone services in this basket; (3) set the initial price cap indices for the video dialtone basket to reflect the video dialtone rates in effect when the service is brought under price cap regulation; (4) decline to establish service subcategories for the price cap basket at this time, but impose a lower pricing band; (5) require LECs to segregate video dialtone costs and revenues from those for telephony service for purposes of sharing and the low-end adjustment once LEC provision of video dialtone exceeds a *de minimis* threshold; and (6) decline to establish sharing and low end-adjustments for the video dialtone basket for LECs exceeding the threshold. We also initiate a Third Further Notice of Proposed Rulemaking to seek comment on the specific level for the *de minimis* threshold as well as on procedures for allocating costs to the video dialtone basket for purposes of sharing and the low-end adjustment once a LEC has exceeded the threshold. This Order does not govern charges that program packagers that use video dialtone service may assess to end users for video programming.

B. BACKGROUND

2. In 1992, the Commission modified its rules to permit LECs to offer video dialtone service.[2] Video dialtone consists of: (1) a basic transmission[3] service available on a non-discriminatory basis to multiple video programmers and a means by which customers of video programmers can obtain access to any or all video programming offered over the transmission platform; and (2) optional enhanced and other non-common carrier products and services related

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[1] In the Matter of Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone services Under Price Cap Regulation, CC Docket No. 94-1, Further Notice of Proposed Rulemaking, 10 FCC Rcd 3141 (1995) (*Video Dialtone FNPRM*).

[2] *See* Telephone Company-Cable Television Cross Ownership Rules, Sections 63.54-63.58, Further Notice of Proposed Rulemaking, First Report and Order, and Second Further Notice of Inquiry, 7 FCC Rcd 300 (1991), *recon.,* 7 FCC Rcd 5069 (1992), *aff'd sub nom.,* National Cable Television Association v. FCC, 33 F.3d 66 (D.C. Cir. 1994); Telephone Company-Cable Television Cross Ownership Rules, Sections 63.54-63.58, Second Report and Order, Recommendation to Congress, and Second Further Notice of Proposed Rulemaking, 7 FCC Rcd 5781 (1992) (*Video Dialtone Order*), *appeal pending sub nom.,* Mankato Citizens Telephone Company, No. 92-1404 (D.C. Cir. filed Sept. 9, 1992) and *modified on recon.,* Memorandum Opinion and Order On Reconsideration and Third Further Notice of Proposed Rulemaking, 10 FCC Rcd 244 (1994) (*Video Dialtone Reconsideration Order*).

[3] When describing video dialtone service, use of the term "transmission" is not intended to connote control over content as that term is used in *National Cable Television Association v. FCC*, 33 F. 3d 66 (1994).

to video dialtone.[4] In the *Video Dialtone Order*, the Commission set forth a two-part regulatory scheme. For the "basic" transmission service, LECs must comply with the common carrier tariffing and non-discrimination requirements of Title II. LEC provision of video-dialtone-related "enhanced" and other non-common carrier services and products are subject to applicable enhanced services and other safeguards.[5]

3. The market for LEC basic video dialtone service currently consists primarily of video program packagers seeking to transmit video programming to end users. Basic video dialtone service provides these programmers with a means of reaching customers in the home through wireline distribution of their programming. LEC video dialtone services are offered on a common carrier basis, enabling a program packager or provider to purchase the amount of transmission capacity it needs on an on-going basis to transmit programming to end users. Transmission capacity on cable systems is generally reserved for use by the cable operator for the transmission of programming of its choosing.[6] Program packagers or providers using LEC video dialtone to transmit programming to consumers will compete with cable systems in the provision of video entertainment to the home. LEC basic common carrier video dialtone service by itself, however, does not compete directly with cable service provided to customers in the home. Instead, video dialtone service is one component of the video entertainment service offered by program packagers and providers to end users. Video dialtone service can be viewed as analogous to the transmission component of the integrated cable offering.

4. In the *Video Dialtone Order* and the *Video Dialtone Reconsideration Order*, we noted the recommendation of several parties that the Commission strengthen the existing safeguards against cross-subsidization through the adoption of rules specifically designed to identify and prevent the flow of subsidies between video dialtone offerings and other regulated interstate telecommunications services.[7] The Commission concluded in the *Video Dialtone Reconsideration Order* that the basic video dialtone offerings of LECs would be subject to the existing price cap rules. We decided that video dialtone constituted a new service under the price cap rules because it adds to the range of options available to customers. Consistent with our new services rules, we stated that LECs must craft their video dialtone rates to cover the "direct costs"

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[4]*Video Dialtone Order*, 7 FCC Rcd at 5806-5807.

[5]*See* Video Dialtone Order, 7 FCC Rcd at 5810-12, 5827-29.

[6]*See* note 37 *infra*.

[7]*See Video Dialtone Order*, 7 FCC Rcd at 5824-27; *Video Dialtone Reconsideration Order*, 10 FCC Rcd at 319-321.

associated with providing the service.[8] Furthermore, we stated that we would seek comment in a supplemental notice on whether to establish a separate price cap basket for video dialtone.[9]

5. The Commission's price cap rules are designed to replicate the incentives of a competitive marketplace to the extent possible and increase LEC incentives for efficiency. The price cap rules afford LECs substantial pricing flexibility within limits designed to protect customers from unreasonably high rates and discriminatory pricing practices.[10] Under Section 61.42(d) of the Commission's Rules, price cap LECs must divide the rate elements of their various interstate services among four baskets - common line, traffic sensitive, trunking, and interexchange. The aggregate price levels of services grouped within each of these baskets are constrained by the price cap index (PCI) assigned to that basket.[11] Services within the traffic sensitive and trunking baskets are also divided into separate service categories. Price changes within the service categories are limited by rate bands applied to the Service Band Index (SBI),

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[8]We specified that direct costs include costs associated with the primary plant investment that is used to provide the service. We noted that in the case of video dialtone, some of these plant costs will be incremental costs associated with plant dedicated to video dialtone service. We also stated that the direct costs of video dialtone will include incremental costs that are associated with shared plant used to provide video dialtone and other services. We also stated that we expect LECs to include as part of direct costs, a reasonable allocation of other costs that are associated with shared plant used to provide video dialtone and other services; and costs in accounts other than primary plant accounts that are reasonably identifiable as incremental costs of video dialtone service. We also required a reasonable allocation of overheads. *Video Dialtone Reconsideration Order,* 10 FCC Rcd at 345-46.

[9]*Id.* at 347.

[10]*See* Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd 6786, 6811 (1990) (*LEC Price Cap Order*), Erratum, 5 FCC Rcd 7664 (Com. Car. Bur. 1990) *modified on recon.*, 6 FCC Rcd 2637 (1991) (*LEC Price Cap Reconsideration Order*).

[11]The PCI for the traffic sensitive, trunking, and interexchange baskets is calculated based upon three main elements -- an inflation factor, a "productivity offset," or X-Factor, which reflects unit cost changes, and exogenous costs. The inflation factor is based on the Gross Domestic Product Price Index (GDP-PI). The X-Factor, which is subtracted from the inflation factor to determine the price cap for the basket, is the historic difference between inflation and the percentage change in the LECs' cost per unit of output. The resulting figure is also adjusted for a limited set of exogenous cost changes, i.e., those generally attributable to administrative, legislative, or judicial action beyond the carrier's control and not otherwise reflected in price cap calculations. *See LEC Price Cap Order,* 5 FCC Rcd at 6792-6801. The formula for the common line basket is slightly different because actual loop costs, while non-traffic sensitive, are recovered in part through rates based upon usage. *See Id.* at 6794-95.

an index of rates within each of the service categories.[12] Service categories limit a LEC's ability to offset price increases for one service in a basket with a reduction in price of another service in a different category in the same basket.[13] As part of the LEC price cap plan, streamlined tariffing procedures apply to rate changes that are consistent with the PCI and any service category bands associated with the service.

6. Under the auspices of the *Price Cap Performance Review* docket,[14] the Commission issued a Further Notice of Proposed Rulemaking seeking comment on the desirability of a separate video dialtone basket, as well as on the need for certain associated revisions to the price cap rules.[15] Specifically, we asked for comment on: (1) whether we should create a separate price cap basket for interstate rate elements associated with LEC provision of basic video dialtone and/or other "broadband" services;[16] (2) what productivity factor we should apply to video dialtone services;[17] (3) whether to set the initial price cap index for video dialtone based upon the existing new services rules or in accordance with some other method;[18] (4) whether we should establish pricing bands for separate service categories within the video dialtone/broadband basket;[19] and (5) whether we should permit LECs to include video dialtone costs and revenues with telephony costs and revenues in their rate of return calculation for use with the sharing and low-end adjustment mechanisms.[20] Seventeen parties filed comments in response to the *Video Dialtone FNPRM*[21] and fourteen parties filed replies.[22]

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[12]47 C.F.R. § 61.47.

[13]*See, e.g.,* Transport Rate Structure and Pricing, 9 FCC Rcd 615, 622-23 (1994).

[14]*See* In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, FCC 95-132 at para. 99 (rel. Apr. 7, 1995) (*Price Cap Performance Review Order*).

[15]*Video Dialtone FNPRM*, 10 FCC Rcd 3141 (1995).

[16]*Video Dialtone FNPRM* at 3147-49.

[17]*Id.* at 3150-51.

[18]*Id.* at 3151-3152.

[19]*Id.* at 3152-53.

[20]*Id.* at 3153-55.

[21]Ad Hoc Telecommunications Users Committee (Ad Hoc Committee), AT&T Corporation (AT&T), Bell Atlantic, BellSouth Telecommunications, Inc. (BellSouth), California Cable Television Association (CCTA), Cox Enterprises, Inc. (Cox), General Services Administration (GSA), GTE Service Corporation (GTE), MCI Telecommunications Corporation (MCI), National

II. DISCUSSION

A. SEPARATE BASKET

1. Comments

7. Many of the LECs reiterated their arguments from previous proceedings that video dialtone should not be subject to price cap regulation.[23] In their view, such regulation is unnecessary since: (1) video dialtone must compete directly with monopoly cable services; (2) LECs, as new entrants in the video program distribution market, have no market power; and (3) cross-subsidization of video dialtone with interstate and intrastate revenues is highly unlikely given the close regulation of interstate and intrastate access services by the FCC and the states respectively.[24] To the extent that video dialtone is regulated at all, these commenters expressed a preference for non-dominant or streamlined treatment of video dialtone similar to that of non-price cap AT&T services.[25] GTE asserted that streamlined regulation is particularly appropriate when the video dialtone provider is entering a market served by an established cable firm.[26]

8. Most LECs agreed with other commenters[27] that assuming a price cap regime applies to video dialtone services, the Commission should create a separate basket for video

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Cable Television Association (NCTA), The NYNEX Telephone Companies (NYNEX), Pacific Bell, Rochester Telephone Corporation (Rochester), Southwestern Bell Telephone Company (SWBT), now SBC Communications, Inc., United and Central Telephone Companies (United), United States Telephone Association (USTA), and US West Communications, Inc. (US West) filed comments.

[22]Ad Hoc Committee, AT&T, Bell Atlantic, CCTA, Cox, GSA, GTE, MCI, NCTA, New England Cable Television Association, Inc. (NECTA), NYNEX, Pacific Bell, and US West submitted replies.

[23]*Video Dialtone Reconsideration Order*, 10 FCC Rcd at 321 (1994).

[24]*See, e.g.*, Comments of USTA at 2-3; Comments of Rochester at 2-6; Comments of Bell Atlantic at 2-5. Bell Atlantic also resubmitted an Affidavit by economist Alfred E. Kahn, finding that there is no economic justification for keeping video dialtone under price cap regulation. Comments of Bell Atlantic at Attachment 1.

[25]*See, e.g.*, Comments of Rochester at 2-5; Comments of NYNEX at 1-2.

[26]Comments of GTE at 4-5.

[27]*See, e.g.*, Comments of AT&T at 3-4; Comments of Cox at 15-16; Comments of CCTA at 5-7.

dialtone.[28] BellSouth, however, argued that video dialtone should be included in the trunking basket with other transport services. It maintained that existing bands and indices would serve as a sufficient safeguard against cross-subsidization.[29]

9. The record also reflects substantial agreement that it would be premature at this time for the Commission to include other "broadband" services in the video dialtone basket.[30] Pacific Bell noted that if in the future the Commission decides to incorporate other broadband services in the basket, it should only include those services with a high degree of cross-elasticity with, or substitutability for, video dialtone. In its view, mere technical similarity would not be sufficient to warrant inclusion in the basket.[31] In contrast, Ad Hoc Committee asserted that the video dialtone basket should include all similar mass media distribution-related services.[32]

10. Cox argued that LEC provision of video programming to end users over their own video transport facilities constitutes cable television service and that LEC services and facilities involved should be regulated under Title VI,[33] citing *NCTA v. F.C.C.*[34] Unless the Commission treats LEC video programming and the associated facilities as a Title VI service, Cox warned, the Commission will create a situation where similarly situated services are operating under disparate regulatory frameworks -- a result contrary to the Commission's stated goal of regulatory parity.[35]

2. Discussion

11. In the *Video Dialtone Reconsideration Order*, the Commission concluded that price cap LECs should be subject to existing price cap rules for the provision of video dialtone services. In reaching this conclusion, the Commission rejected the argument that LECs are

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[28]*See, e.g.*, Comments of SWBT at 3-4; Comments of GTE at 13-14; Comments of US West at 12-13; *see also* Reply of Ad Hoc Committee at 2-4; Rely of AT&T at 2; Reply of CCTA at 12-13; Reply of Cox at 7; Reply of GSA at 2-3; Reply of GTE at 7-8; Reply of MCI at 2-7; Reply of NECTA at 2-4; Reply of NYNEX at 2; Reply of US West at 1.

[29]Comments of BellSouth at 4-7.

[30]*See, e.g.*, Comments of CCTA at 6; Comments of MCI at 7-8.

[31]Comments of Pacific Bell at 7.

[32]Comments of Ad Hoc Committee at 10-11.

[33]Comments of Cox at 4-5.

[34]*NCTA v. F.C.C.*, 33 F.3d 66 (D.C. Cir. 1994).

[35]*Id.* at 5.

nondominant in the provision of video dialtone service. The Commission observed that LECs offering video dialtone service maintain control over an essential bottleneck facility, the basic common carrier video dialtone platform, used to transmit video programming to consumers, and thus retain control over the price of video dialtone service. The Commission concluded that "[u]ntil actual facilities based competition gives video service providers access to several outlets for the distribution of their services, regulation of the common carrier [video dialtone] platform is necessary to ensure that rates charged for access to the basic platform are just and reasonable."[36]

12. The record in this proceeding, in our view, does not demonstrate that we should reconsider our conclusion in the *Video Dialtone Reconsideration Order* at this time. No party has shown that the market conditions for video dialtone service on which we based our findings have changed materially over the past several months. The LECs will continue to control the common carrier transmission facilities independent program packagers use to reach consumers. Moreover, independent program packagers (*i.e.*, those not affiliated with an owner of video transmission facilities) currently have limited alternatives to LEC video dialtone for transmitting their programming to end users.[37] In markets where video dialtone service is provided, LECs will likely serve as the predominant providers of video transport services to independent program packagers, thus maintaining a potential bottleneck over access to end users by program packagers not integrated with a facilities-based distribution medium such as cable. While independent program packagers can construct their own distribution networks using traditional cable facilities or wireless delivery systems, "backward integration" by these firms through the construction of such facilities, would entail large upfront investments that would likely discourage independent program packagers from adopting this strategy for entry. It is also possible that systems that provide video dialtone and telephony over integrated facilities will prove to have certain efficiencies that stand-alone systems will not have.

13. We believe that we should proceed cautiously by applying price cap regulation to video dialtone at this time. We recognize that video program packagers using LEC basic video dialtone service as a component of their video entertainment services will compete directly with cable operators and other services that provide multichannel video programming services to consumers in the home through different distribution facilities. This competition should bring downward pressure to bear on the charges consumers pay for these video programming services. This "downstream" competition should also influence LEC rates for video dialtone service used by independent program packagers and may well constrain the LEC's pricing of video dialtone

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[36]*Video Dialtone Reconsideration Order*, 10 FCC Rcd at 339-340.

[37]Cable operators currently provide leased access for independent programmers on a limited basis. They are generally required to devote 60 percent of their capacity to the carriage of unaffiliated programming, although the cable operator selects the unaffiliated programming it will carry, except for leased access, must carry, and public, educational and governmental programming requirements. *See* 47 U.S.C. §§ 531, 532, 534, & 535.

service. At present, however, we lack any concrete experience or empirical data concerning the effectiveness of "downstream" competition in ensuring that rates for video dialtone are just and reasonable and nondiscriminatory. Further, LECs may offer video dialtone services, such as digital transmission service, that are used to provide video services to end users that are not offered by competing providers.

14. To the extent that downstream competition in the provision of multichannel video entertainment services by wire and wireless providers, or the availability of other distribution media, do constrain the pricing of video dialtone services, we believe that the pricing flexibility granted to LECs in this order for services placed in the video dialtone basket will enable LECs to adjust their prices in response to marketplace forces. At the same time, the price cap index applicable to the basket and the limits on price reductions will operate to ensure that rates remain just and reasonable.[38] We anticipate that competitive alternatives to video dialtone will develop and grow over time. We also expect that experience will provide us with concrete information on the effect that downstream competition should have in constraining LEC video dialtone prices. Thus, we recognize that as deployment of video dialtone service produces empirical evidence about the dynamics of the market for this service, it may well be appropriate to reexamine the desirability of granting LECs streamlined regulation of, or eliminating price cap regulation for, video dialtone services.

15. Accordingly, we conclude that the basic video dialtone offerings of price cap LECs should be included in a new, separate price cap basket. The record supports our initial view in the *FNPRM* that video dialtone service differs sufficiently from basic telephony services in the other price cap baskets to warrant the creation of its own basket. While video dialtone will share certain facilities with telephony, LEC video dialtone offerings will serve a different market with different customers and competitive characteristics. Furthermore, we believe, as many of the commenters stated, that a separate basket is appropriate in this instance to help prevent potential cross-subsidization that could occur if we placed dissimilar services with different sets of customers and competitors in the same basket.

16. We also conclude that the video dialtone basket should not include any other "broadband" services at this time. We agree with the commenters that technical similarity alone is not a sufficient basis for including other broadband services in this new basket. As we gain more experience with video dialtone and other such video distribution services, we will be better able to determine what product and market characteristics are required for a service to be included in the video dialtone basket.

17. Finally, we wish to address Cox's concern over the appropriateness of our common carrier regulatory approach. We believe, as we have stated previously, that LEC provision of basic video dialtone to third party video programmers is properly regulated as a common carrier

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[38] 47 U.S.C. § 201 (b).

activity.[39] In this order, we are addressing the suitability of the price cap system for regulating basic video dialtone rates, not program packagers' charges to consumers for video programming or entertainment services.

B. PRODUCTIVITY FACTOR

1. Comments

18. A number of the commenters expressed concern that the Commission might hamper the growth of video dialtone by placing more stringent requirements on video dialtone than on the provision of cable services. They recommended that the Commission assign to video dialtone a zero productivity factor just as it has for cable service.[40]

19. GSA and MCI proposed that the Commission apply the telephony interstate access productivity factor to video dialtone. According to GSA, there is no difference in basic technology and therefore no justification for allowing video dialtone to carry a lower productivity offset. GSA is concerned that if the productivity offset is too low, prices will be too high and demand for the service will be depressed.[41] MCI stated that the lack of historical perspective and data makes it virtually impossible for the Commission to derive reasonable estimates for productivity factors. Thus, MCI concluded that the Commission should apply existing telephony productivity offsets.[42]

20. SWBT argued that the Commission should set an "interim" productivity factor of 2 percent, predicated upon the eventual removal of video dialtone from price cap regulation within one year. The 2 percent figure represents the average of the minimum 4 percent productivity factor adopted in the *LEC Price Cap Review Order* and the 0 percent productivity factor set in the cable television price cap plan.[43] According to SWBT, this approach would be analogous to the Commission's treatment of the productivity offset for the LECs' interexchange

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[39]*See NCTA v. F.C.C.,* 33 F.3d 66 (D.C. Cir. 1994).

[40]*See, e.g.*, Comments of NYNEX at 6-7; Comments of USTA at 4; Comments of GTE at 19-20; Comments of Bell Atlantic at 6; *see also* Reply of Ad Hoc Committee at 5-6; Reply of Bell Atlantic at 4-5; Reply of CCTA at 13; Reply of Cox at 11-12; Reply of GTE at 8-9; Reply of NCTA at 4; Reply of NYNEX at 4; Reply of Pacific Bell at 8; Reply of US West at 2.

[41]Comments of GSA at 4-5.

[42]Comments of MCI at 10-11.

[43]Comments of SWBT at 5.

services.[44] A few commenters suggested that it was premature to consider a productivity factor at all and that the Commission should revisit the matter after video dialtone service has been in the market for a period of time.[45]

21. The Ad Hoc Committee believes that the Commission should disaggregate the average productivity or "X-Factor" adopted in the price cap review. It suggests that the factor for the video dialtone basket should be set equal to zero and the non-video X-Factor should be set at higher level than exists today in order to keep the overall average constant. Ad Hoc argues that such disaggregation is necessary to ensure that LECs flow through savings associated with improvements to common network facilities to voice customers.[46] Bell Atlantic, took issue with Ad Hoc's position, arguing that there is no factual basis to suggest that average productivity growth would have been higher but for the video dialtone networks of the LECs.[47]

2. Discussion

22. The price cap indices applicable to LEC price cap baskets are adjusted each year by an amount equal to inflation less the productivity or X-Factor. The X-Factor is an offset that reflects the fact that, historically, telephone carriers have experienced efficiency gains and decreases in input prices in excess of those for the general economy, resulting in changes in telephone and interstate access rate levels that are below the level of inflation.[48] In determining the appropriate X-Factor for telephony services, we have looked to the historical costs and productivity of the relevant industry as well as to data from independent and Commission-sponsored studies.[49] Video dialtone differs from the provision of other LEC services in certain respects. For example, it serves different customers than most other LEC services and uses different equipment to some extent. In the case of video dialtone, we have no record of industry or service productivity upon which to rely in setting the X-Factor.

23. Until more information becomes available, we believe it is reasonable to set the initial X-Factor for the video dialtone basket at zero. In our view, the record in this proceeding does not demonstrate that LEC productivity gains in the provision of video dialtone service will equal or exceed historic productivity gains in the provision of telephony. We have also used a

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[44]*Id.*

[45]*See, e.g.*, Comments of Pacific Bell at 7-8; Comments of CCTA at 10-11; Comments of United at 2-3; *see also* Comments of Cox at 21-25.

[46]Comments of Ad Hoc Committee at 12-13; *see also* Reply of MCI at 9.

[47]Reply of Bell Atlantic at 5.

[48]*See Price Cap Performance Review Order* at para. 99.

[49]*Id.* at para. 202.

zero X-Factor in the context of cable rate regulation when we lacked record information on historic productivity of the cable industry.[50] A zero X-Factor will ensure that, under a worst case scenario, rates for video dialtone can rise at no more than the rate of inflation, absent exogenous cost increases.[51] However, we believe that LEC basic video dialtone rates will be influenced by the price of the cable service offerings with which the LEC programmer-customers will compete. Thus, while we believe that price cap regulation is appropriate at this time as previously discussed,[52] we expect that actual video dialtone prices will remain below the maximum levels permitted by the price cap index. Under these circumstances, we believe that a zero X-Factor is reasonable at present, although we will revise the X-Factor in the future if circumstances warrant.

24. For similar reasons, we believe that the record does not support adoption of SWBT's suggestion of a 2 percent productivity factor. We are also unpersuaded by Ad Hoc's proposal for an increased X-Factor for interstate access in conjunction with a zero X-Factor for video dialtone. Ad Hoc has not shown why the provision of video dialtone should increase productivity for telephony services sufficiently to warrant an immediate increase in the X-Factor for interstate telephony services.

C. SETTING THE INITIAL CAP

1. Comments

25. Commenters generally supported setting the video dialtone price cap index based on the rates developed under the new services rules.[53] There was some disagreement, however, over how long to exclude video dialtone from price caps and the regulatory measures that should apply before video dialtone is brought under price caps. For example, Pacific Bell suggested

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[50]Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992 - - Rate Regulation, 9 FCC Rcd 5760 (1994); *Video Dialtone FNPRM*, 10 FCC Rcd at 3150.

[51]Exogenous costs are generally limited to those attributable to administrative, legislative, or judicial action beyond the carrier's control and not otherwise reflected in price cap calculations. *See* Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786 (1990), Erratum, 5 FCC Rcd 7664 (Com. Car. Bur. 1990), *modified on recon.*, 6 FCC Rcd 2637 (1991).

[52]*See* paras. 12 & 13 *supra*.

[53]*See, e.g.*, Comments of AT&T at 4-5; Comments of United at 2-3; Comments of GTE at 17-18; Comments of SWBT at 6; Comments of USTA at 5; Comments of US West at 16-18; Comments of MCI at 11; *see also* Reply of GTE at 7; Reply of Bell Atlantic at 6; Reply of AT&T at 2-3.

an exclusion of up to 5 years[54] and US West expressed its preference for a one year period of streamlined regulatory treatment with significant pricing flexibility before applying price cap regulation to video dialtone.[55] GTE stated that LECs should be able to adjust rates on 14 days notice once the initial rates are in place, with any index adjustments made at the next annual filing.[56] Pacific Bell argued that such flexibility is necessary in order for LEC providers to recover start-up costs and determine pricing strategy in a new, yet fast-growing market.[57]

26. Several parties urged us to give initial LEC video dialtone cost studies rigorous review.[58] Since video dialtone prices must, at minimum, cover incremental cost, NCTA urged the Commission to define clearly what costs it considers "incremental" before approving any initial rates.[59]

2. Discussion

27. We affirm our tentative conclusion in the *FNPRM* and will establish the initial rates to be included in the video dialtone basket based upon the price cap new services test, as applied to video dialtone services.[60] Consistent with this approach, we will incorporate video dialtone rates into the new price cap basket in the first annual price cap tariff filing following the calendar year in which the new service is first offered, which may occur anywhere from six to eighteen months from the introduction of service.[61] Moreover, as we have done with other price cap baskets, we will assign an initial value of 100 to the PCI and the actual price index (API) for video dialtone service prior to adjustment for inflation and productivity, corresponding to the rates in effect just prior to the effective date of the annual filing in which rates for video dialtone service are included in the new basket we are creating.[62] We will adjust the PCI and the API if

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[54]Comments of Pacific Bell at 5.

[55]Comments of US West at 16-17. *See also* Comments of Pacific Bell at 5-6.

[56]Comments of GTE at 18.

[57]Comments of Pacific Bell at 5-6.

[58]*See, e.g.*, Comments of Ad Hoc Committee at 17; Comments of CCTA at 7-9; Comments of Cox at 16-20.

[59]Comments of NCTA at 4-6.

[60]*Video Dialtone Reconsideration Order*, 10 FCC Rcd at 344-346.

[61]47 C.F.R. § 61.42 (g).

[62]*See, e.g.* 47 C.F.R. § 61.42.

necessary to reflect the results of video dialtone rate investigations ongoing at the time video dialtone rates are brought under price caps.

28. We find no compelling reason presented in the record of this proceeding to justify changing the conclusions we reached in the *Video Dialtone Reconsideration Order* setting forth the application of the new services rules to video dialtone. We see no reason to keep video dialtone outside price cap regulation for an extended period of time. Moreover, we do not believe it is presently appropriate to allow LECs to modify rates on 14 days notice rather than on the full 45 day notice period that currently applies before new services are brought under price cap regulation. Given that video dialtone is a new service in a new market, we believe that a shortened notice period may harm the ability of interested parties to participate in the tariff review process. Moreover, we see no reason to elaborate on the new services test as applied to video dialtone in this proceeding. To the extent further explication of the new services test is appropriate, it should take place in the tariff review process or other proceedings. We have already taken steps in the *Video Dialtone Reconsideration Order* to ensure that initial video dialtone rates are cost justified by providing the LECs with guidance on standards we will apply to video dialtone rates under the new services test.[63] We believe the existing rules are sufficient to address concerns over initial rates, and conclude that the adoption of new measures in this proceeding is unnecessary.

D. SUBCATEGORIES

1. Comments

29. There was almost universal agreement in the record that service sub-categories with pricing bands are unnecessary for the video dialtone basket at this time.[64] The commenters argue that video dialtone service will begin with no market share and compete with established cable companies, satellite TV distribution services, and video rental outlets. Given the available alternatives, a majority of the commenting parties believe it would be inappropriate for the Commission to establish service sub-categories and pricing bands in order to simulate a competitive market environment.[65] In contrast, GSA asserts that separate service categories should be established for end user and customer programmer charges to ensure a degree of rate

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[63] *See Video Dialtone Reconsideration Order*, 10 FCC Rcd at 344-346.

[64] *See, e.g.*, Comments of NCTA at 7; Comments of SWBT at 7. Comments of MCI at 11. *But see* Reply of GTE at 7.

[65] *See, e.g.*, Comments of Rochester at 7-8; Comments of Pacific Bell at 6-7.

stability.[66] Moreover, Cox, CCTA, Ad Hoc, and MCI argue that some form of pricing floor is essential to inhibit predatory pricing.[67]

2. Discussion

30. While we do not fully share the commenters' views on the competitive nature of video dialtone service, we agree that dividing the video dialtone basket into separate subcategories is undesirable at this time. Video dialtone is a nascent service for which LECs have just begun to file tariffs, and we expect that the LECs will employ a variety of architectures to deliver their offerings which could lead to varying rate structures for video dialtone services. Thus, it would be difficult to create a stable set of service categories within the new video dialtone basket at this time.

31. We do believe, however, that a separate basket in and of itself may not be sufficient to protect the public interest. The rates LECs charge programmers will be constrained initially by the requirements of our price cap new services test, which ensures that the initial rate levels are just and reasonable. Thereafter, rates are constrained on the upper end by the PCI, which will prevent prices from rising faster than the rate of inflation, absent exogenous cost increases. Moreover, as discussed above, competition for in-home video entertainment should also help to constrain LEC prices. The combination of video dialtone rates charged to programmer-customers plus other costs that programmer-customers incur to provide programming to consumers, such as program license fees, must be competitive with cable and other video distribution offerings. Once under price cap regulation, rates on the low end do not have the same built-in constraints that prices on the high end do. In the *Video Dialtone Reconsideration Order*, we expressed a concern about the potential for unreasonably low prices for video dialtone services "because video dialtone is an essential component of a multichannel video service that will compete directly" with various multichannel video programming providers.[68] In addition, a number of parties argue here that we should adopt some form of price floor. As a result, we believe that it is desirable to impose a lower band on the video dialtone basket in addition to the protection provided by the new services test. Accordingly, LEC tariff filings reducing prices in excess of 15 percent per year relative to the PCI will not carry of a presumption of lawfulness. This is the same lower price band that we have applied to LEC services in the context of zone density pricing.[69] In these circumstances, we believe that this price band strikes a reasonable balance between providing LECs with appropriate pricing flexibility and guarding against potentially anticompetitive rate decreases. Consistent with existing procedures, filings to

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[66]Comments of GSA at 6.

[67]*See, e.g.*, Comments of Ad Hoc Committee at 6 n.6; Comments of Cox at 16-18; Comments of MCI at 10-11; Comments of CCTA at 7-10.

[68]*Video Dialtone Reconsideration Order*, 10 FCC Rcd at 344.

[69]*Price Cap Performance Review Order*, FCC 95-132 at para. 411.

implement rates below this level must be made on 45 days' notice, and be accompanied by a showing that the rates exceed average variable costs consistent with the cost support requirements specified in Section 61.49 (d) of the Commission's Rules.

32. We note that we are today proposing to eliminate the lower pricing bands for LEC price cap services in the Second Further Notice in the LEC Price Cap Performance Review.[70] We are not prepared to forego establishment of a lower band for video dialtone before we have an opportunity to evaluate the record in that proceeding. As we gain experience with video dialtone and as the record develops in the Second Further Notice, we may find it appropriate to reconsider the need for a lower band for video dialtone service. In the interim, we believe that we should follow a conservative approach given our limited experience with the provision of video dialtone service. Moreover, we note that under the existing regulatory scheme, LECs may proffer a cost showing if they determine a need exists to price video dialtone transmission below the band. Thus, the lower price band will not prohibit any cost-justified rate reduction.

E. SHARING AND LOW-END ADJUSTMENTS

1. Comments

33. A majority of the commenters argued that the costs and revenues associated with a video dialtone basket should not be included with those from other baskets to compute a LEC's interstate earnings for the purposes of sharing and low end adjustments.[71] Most of the parties argued that, given the initial expected investment and relatively low revenue for video dialtone, inclusion of these components would enable a LEC to cross-subsidize its video dialtone venture with telephony revenue.[72] The LECs supporting the exclusion of video dialtone from sharing and the low-end adjustment for other price cap services argued that this approach was necessary in order to assuage concerns over potential cross-subsidization and earnings manipulation.[73]

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[70]Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1, Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197, FCC 95-393, adopted Sept. 14, 1995.

[71]Comments of Ad Hoc at 19-20; Comments of AT&T at 5-7; Comments of CCTA at 12-14; Comments of Cox at 25-27; Comments of GSA at 5-6; Comments of MCI at 12-13; Comments of NCTA at 8-9; Comments of NYNEX at 10; Comments of Rochester at 9; Comments of United at 3-4; Comments of US West at 14.

[72]*See, e.g.*, Comments of AT&T at 5-7; Comments of GSA at 6-7; Comments of Ad Hoc Committee at 19-20.

[73]*See, e.g.*, Comments of NYNEX at 10; Comments of US West at 14.

34. BellSouth, SWBT, Pacific Bell, and GTE, however, argued that the Commission should treat video dialtone like any other LEC price cap service and allow LECs to include video dialtone costs and earnings for purposes of their sharing and low-end adjustment calculations.[74] They also argue that the Commission should continue the move toward a pure price cap plan, and should not tie video dialtone regulation to earnings during this interim period.

2. Discussion

35. Consistent with our concern regarding the possibility of cross-subsidization of LEC video dialtone service, we will exclude video dialtone costs and revenues from the calculation of a LEC's earnings from other regulated interstate services for purposes of sharing and the low-end adjustment once video dialtone costs are no longer *de minimis*. Under this plan, price cap LECs will be allowed to include video dialtone costs and revenues with those from other baskets for purposes of sharing and low-end adjustment calculations so long as their video dialtone costs are below a specified threshold. At this juncture, it appears that many of the LECs intending to provide video dialtone will begin with small systems capable of serving a limited number of households. Thus, in the early years, video dialtone investment for at least certain LECs may well be too small to have a significant effect on the LEC's overall interstate earnings as computed for sharing and the low-end adjustment. We believe that establishment of a *de minimis* threshold can be a much simpler matter than the application of an actual cost allocation methodology for assigning costs to the video dialtone basket for purposes of sharing and the low end adjustment. Thus, until a LEC passes such a threshold, we believe that excluding video dialtone costs and revenues from this calculation is an unnecessary administrative burden. Once a LEC's costs rise above a *de minimis* level, however, we will require the LEC to exclude video dialtone costs and revenues from its interstate rate of return calculations for sharing and the low-end adjustment. Excluding video dialtone data at that point will ensure that potentially low initial earnings on video dialtone will not significantly reduce overall LEC earnings, and, as a result, will not potentially reduce sharing obligations. We seek comment in a subsequent section of this order on the specific standard for the *de minimis* threshold and the cost allocation methodology LECs must follow. We hereby delegate authority to the Chief, Common Carrier Bureau to take the actions necessary to implement these requirements.[75]

36. In cases where a LEC's video dialtone investment has passed the *de minimis* threshold, and it is required to allocate costs to a separate video dialtone basket for price cap purposes, we must consider whether it is appropriate to establish a separate sharing and low end adjustment mechanism applicable to the new video dialtone basket. In such situations, we

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[74] Comments of BellSouth at 12-14; Comments of SWBT at 7-9; Comments of Pacific Bell at 8-10; Comments of GTE at 17.

[75] The Commission, however, will determine the level of the *de minimis* threshold and the method for allocating costs to the new video dialtone basket based on the record developed in response to our request for comments. *See* paras. 39-42 *infra*.

conclude that sharing should not be required and that a low-end adjustment should not be allowed for the video dialtone basket. In light of the substantial start-up costs for video dialtone, we do not expect LECs to generate earnings high enough to warrant the imposition of sharing. These price cap mechanisms originally were created to compensate for any inaccuracies in the X-Factor as applied to the industry as a whole or to individual companies. While we have chosen a zero X-Factor for video dialtone, we expect that competition will produce downward pressure on rates, limiting a LEC's ability to generate high earnings. Under these circumstances, we anticipate that video dialtone customers will share in productivity gains through rate reductions and thus we do not believe a sharing mechanism is necessary. Given that the X-Factor we are applying does not place downward pressure on video dialtone rates and will allow LEC video dialtone rates to keep pace with inflation, we believe there is no need for a low-end adjustment. We also note that a zero X-Factor is very conservative when compared to the 4.0, 4.7 and 5.3 percent X-Factors used for interstate access services.

F. OTHER ISSUES

1. Comments

37. A number of parties stated that a separate basket alone was not enough to protect against cross-subsidization and predatory pricing.[76] Some suggested again, as they did in the *Video Dialtone Reconsideration* proceeding, that the Commission should amend Part 64 to establish specific video dialtone cost allocation rules, as well as Part 69 to establish a separate access charge category for LEC video dialtone rates.[77] For example, Cox argued that the Commission must adopt special rules for the allocation of costs between telephony and video dialtone in order to prevent cross subsidization.[78] Cox suggested that the Commission adopt rules dividing costs between telephony and video dialtone prior to jurisdictional separations.[79] They also propose allowing LECs to allocate a maximum of 50 percent of the costs of a shared network upgrade to regulated telephony. The 50 percent allocated to video dialtone, Cox stated, would subsequently be allocated among regulated and unregulated video/broadband services using

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[76]*See, e.g.*, Comments of GSA at 6-7; Comments of CCTA at 12-14.

[77]*See, e.g.*, Comments of Rochester at 6-7; Comments of MCI at 13-15; Comments of Cox at 16-17.

[78]Cox Statement to Kathleen M.H. Wallman, Chief, Common Carrier Bureau from Sandy Wilson, dated July 12, 1995 (Cox Wallman Statement); Cox Letter to Reed E. Hundt, Chairman, from James O. Robbins, dated June 28, 1995 (Cox Hundt Letter).

[79]Comments of Cox at 16-17. The Commission's jurisdictional separations rules allocate costs between the state and federal jurisdictions. 47 C.F.R. Part 36. Part 64 of the Commission rules is designed to allocate costs between regulated and nonregulated telephone company services. 47 C.F.R. Part 64.

Part 64 procedures. Costs assigned to the regulated video/broadband services would then be subjected to the traditional Parts 36 and 69 analysis in order to establish just and reasonable tariff rates.[80] In addition, some parties urged the Commission to eliminate the Part 69 waiver requirement, stating that continuation of the waiver process will only duplicate existing tariff procedures.[81]

2. Discussion

38. For the reasons already stated, we believe that the steps we are taking here, creating a separate price cap basket for video dialtone services and excluding such services from the calculation of sharing obligations or the low end adjustment once LEC investment in video dialtone exceeds *de minimis* levels, will prevent LECs from unlawfully cross-subsidizing video dialtone service. We decline to address these issues regarding modification of Parts 64 and 69 of our rules further except insofar as they pertain to our request for comments on the allocation of costs to the video dialtone basket. Except to the extent indicated above, we conclude that these matters are beyond the scope of the instant proceeding.[82]

III. THIRD FURTHER NOTICE OF PROPOSED RULEMAKING

39. Having concluded that video dialtone costs and revenues should be segregated from those for telephony service for purposes of sharing and the low-end adjustment once LEC provision of video dialtone exceeds a *de minimis* threshold, we now seek comment on procedures for implementing these measures. We propose basing the *de minimis* threshold on the data carriers are currently required to submit under Responsible Accounting Officer (RAO) Letter 25.[83] In the *Video Dialtone Reconsideration Order*, the Commission directed LECs to establish subsidiary accounting records consistent with the Part 32 Uniform System of Accounts for Telecommunications Companies (USOA) in order to isolate video dialtone related costs and revenues from those associated with LEC telephone services.[84] In RAO 25, the Accounting and Audits Division of the Common Carrier Bureau required LECs to maintain subsidiary records by

[80]Cox Wallman Statement at 2.

[81]*See, e.g.,* Comments of GTE at 16-17. *See also* Reply of Cox at 6, 10-11; Reply of GSA at 10-12.

[82]For example, we believe that it is appropriate to address the need for Part 69 waivers for video dialtone in the context of petitions for reconsideration of the *Video Dialtone Reconsideration Order.*

[83]Responsible Accounting Officer Letter 25, DA 95-703, released Apr. 3, 1995, (RAO 25), *applications for review pending.*

[84]*Video Dialtone Reconsideration Order,* 10 FCC Rcd at 326; RAO 25 at 2.

USOA accounts for all wholly dedicated and shared investment, expense and revenue related to providing video dialtone service. An investment or expense is considered "wholly dedicated" if it is used exclusively for the provision of video dialtone service. Shared investment and expenses are those that are common to, or are used jointly to provide video dialtone and other LEC services.[85]

40. Using the RAO Letter 25 data, the threshold could be set at the amount of dedicated video dialtone investment that would reduce the LEC overall rate of return by a specified amount, such 10 or 25 basis points, for example.[86]

41. We also need to specify a method or factor to be used in Part 69 for allocating video dialtone costs to the video dialtone basket for purposes of sharing and the low-end adjustment once the threshold has been passed in the case of LECs that select an X-Factor with sharing and a low end adjustment for telephony.[87] We could allocate costs to the video dialtone basket using the approach in the new services test applied in the tariff review process for setting video dialtone rates, such as the Commission's investigation of Bell Atlantic's proposed rates for Dover Township, New Jersey.[88] Under this approach, if somewhat different cost allocation methodologies are used for a single LEC due, for example, to differences in technology for various video dialtone systems, we propose to weight the application of the different cost allocation methodologies in some manner. For example, use of the different cost allocation methodologies could be weighted based on video dialtone investment for the relevant systems. As an alternative to use of the new services cost allocation methodology, we seek comment on whether we should adopt a fixed cost allocation factor, such as a specified percentage, and, if so, what level of allocator we should use. We believe such an approach would not be overly burdensome and would be relatively simple to administer. Parties advocating the use of a fixed allocator should explain the basis for their proposal and the public interest goals that would be advanced by use of such an allocator. We also ask interested parties to address the implications of allocating costs to the video dialtone basket on a basis different than that used to set video dialtone rates.

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[85]RAO 25 at 2-3.

[86]The LECs' obligation to submit data pursuant to RAO Letter 25, however, is independent of any action the Commission may take concerning the establishment of a *de minimis* threshold for price cap purposes.

[87]Price Cap LECs have the option of choosing among several X-Factors for the telephony price cap baskets - - 4.0, 4.3, and 5.3. LECs which choose the highest X-Factor of 5.3 are not subject to sharing. *Price Cap Performance Review Order* at paras. 218-224.

[88]*See, e.g.,* In the Matter of Bell Atlantic Telephone Companies Revisions to Tariff F.C.C. No. 10 Rates, Terms, and Regulations, Transmittal Nos. 741, 786, Order, DA 95-1285, rel. June 9, 1995.

42. We seek comment on these proposals and invite parties to suggest alternate sources for the threshold data, and different procedures for setting the threshold. We also invite interested parties to suggest alternative methods for allocating costs to the video dialtone basket once the LEC has exceeded the threshold.

IV. PROCEDURAL MATTERS

A. *EX PARTE* RULES

43. This is a non-restricted notice and comment rulemaking proceeding. *Ex parte* presentations are permitted, except during the Sunshine Agenda period, provided they are disclosed as provided in the Commission's rules.[89]

B. REGULATORY FLEXIBILITY ACT ANALYSIS

44. In the *FNPRM* in this proceeding, we certified that the Regulatory Flexibility Act of 1980 did not apply to this rulemaking proceeding because none of the proposed rules would have a significant economic impact on a substantial number of small business entities, as defined by Section 601 (3) of the Regulatory Flexibility Act. Carriers subject to price cap regulation for local exchange access services affected by the rule amendments adopted in this Order generally are large corporations or affiliates of such corporations.

45. We also certify that the Regulatory Flexibility Act of 1980 does not apply to the Third Further Notice of Proposed Rulemaking because if the proposed rules are promulgated, there will not be a significant economic impact on a substantial number of small business entities, as defined by Section 601 (3) of the Regulatory Flexibility Act. Carriers subject to price cap regulation for local exchange access services affected by the rule amendments under consideration generally are large corporations or affiliates of such corporations.

C. COMMENT FILING DATES

46. Pursuant to applicable procedures set forth in Sections 1.415 and 1.419 of the Commission's Rules,[90] interested parties may file comments on or before October 27, 1995, and reply comments on or before November 17, 1995. To file formally in this proceeding, parties must file an original and four copies of all comments, reply comments, and supporting comments. If parties want each Commissioner to receive a personal copy of their comments, parties must

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[89] *See generally* 47 C.F.R. §§ 1.1202, 1.1203, and 1.1206(a).

[90] 47 C.F.R. §§ 1.415, 1.419.

file an original plus nine copies. Comments and reply comments should be sent to the Office of the Secretary, Federal Communications Commission, Washington, D.C. 20554. Parties should also file one copy of any documents filed in this docket with the Commission's copy contractor, International Transcription Service, Inc., Room 246, 1919 M Street, N.W., Washington, D.C. 20037. Parties should also send one copy of any documents filed in this proceeding to Ms. Janice Myles, Policy and Program Planning Division, Common Carrier Bureau, Room 544, 1919 M Street, N.W., Washington D.C. 20554. Comments and reply comments will be available for public inspection during regular business hours in the FCC Reference Center, Room 239, 1919 M Street, N.W., Washington, D.C. 20554.

V. ORDERING CLAUSES

47. Accordingly, IT IS ORDERED that, pursuant to authority contained in Sections 4 (i), 4 (j), 201-205, 215, 218, 303 (r), and 403 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 154 (i), 154 (j), 201-205, 215, 218 303 (r), 403, and Section 553 of Title 5, United States Code, Part 61 of the Commission's Rules, 47 C.F.R. Part 61, IS AMENDED as set forth in Appendix A.

48. IT IS FURTHER ORDERED that the provisions in this Report and Order will be effective 120 days after FEDERAL REGISTER publication.

49. IT IS FURTHER ORDERED that, pursuant to Sections 1, 4, 201-205, 215, and 218 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 151, 154, 201-205, 215, 218, a THIRD FURTHER NOTICE OF PROPOSED RULEMAKING IS HEREBY ADOPTED and that COMMENT IS SOUGHT on the issues contained therein. Interested parties may file comments on or before October 27, 1995, and reply comments on or before November 17, 1995.

50. IT IS FURTHER ORDERED that, the Secretary shall send a copy of this Second Report and Order and Third Further Notice of Proposed Rulemaking, including the regulatory flexibility certification, to the Chief Counsel for Advocacy of the Small Business Administration, in accordance with Paragraph 605 (b) and Paragraph 603 (a) of the Regulatory Flexibility Act. Pub. L. No. 96-354, 94 Stat. 114, 5 U.S.C. §§ 601 *et seq* (1981).

FEDERAL COMMUNICATIONS COMMISSION

William F. Caton

William F. Caton
Acting Secretary

APPENDIX A

Part 61 of Title 47 of the Code of Federal Regulation is amended as follows:

PART 61 - - TARIFFS

1. The authority citation continues to read as follows:

Authority: Secs. 4 (i), 4 (j), 201-205, 303 (r), and 403 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 154 (i), 154 (j), 201-205, 303 (r), 403, unless otherwise noted.

2. Section 61.42 (d) is amended by adding a new subparagraph (5) to read as follows:

§ 61.42 Price cap baskets and service categories.

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(d) ***

(5) To the extent that a local exchange carrier specified in §§ 61.41(a) (2) or (3) offers interstate video dialtone services, a basket for basic video dialtone services as described in Section 63.54 of this chapter.

3. Section 61.45 is amended by revising paragraph (b) to read as follows:

§ 61.45 Adjustments to the PCI for Local Exchange Carriers

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(b) Adjustments to local exchange carrier PCIs for the baskets designated in §§ 61.42(d) (2), (3), (4), and (5), shall be made pursuant to the formula set forth in §§ 61.44 (b), and as further explained in §§ 61.44 (e), (f), (g), and (h).

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(3) Notwithstanding the value of X defined in § 61.44 (b), the value of X applicable to the basket specified in § 61.42 (d) (5) shall be 0%.

4. Section 61.45 is further amended to revise paragraph (h) to read as follows:

§ 61.45 Adjustments to the PCI for Local Exchange Carriers

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(h) To the extent a local exchange carrier elects the higher productivity factor, the election must be made in all baskets, except the video dialtone services basket, as designated in § 61.42(d)(5).

5. Section 61.47(g) is amended by adding a new subparagraph (6) to read as follows:

§ 61.47 Adjustments to the SBI; pricing bands

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(g) ***

(6) Local exchange carriers subject to price cap regulation as that term is defined in § 61.3 of this chapter shall use the methodology set forth in paragraphs (a) through (d) of this section to calculate a lower pricing band for the basket described in § 61.42(d)(5) of this chapter. The annual pricing flexibility for this basket, as reflected in the API, shall be limited to an annual decrease of fifteen percent, relative to the percentage change in the PCI for that basket, measured from the last day of the preceding tariff year.

6. Section 61.48 is amended by adding paragraph (j) to read as follows:

§ 61.48 Transition rules for price cap formula calculations.

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(j) *Video Dialtone Services.* For local exchange carriers subject to price cap regulation, the video dialtone services basket, as designated in § 61.42(d)(5), shall be established with an initial PCI and API level of 100 in the first annual price cap tariff filing following competition of the base period in which the initial video dialtone service was introduced. The initial value of 100 for the PCI and API for video dialtone service prior to adjustment for inflation and productivity shall correspond to the rates in effect just prior to the effective date of the annual filing in which rates for video dialtone service are initially included in the video dialtone basket.